Supreme Court of the United States

OCTOBER TERM, 1943.

No. 195.

NORTHWESTERN ELECTRIC COMPANY and AMERICAN POWER & LIGHT COMPANY, *Petitioners*,

v.

FEDERAL POWER COMMISSION, *Respondent*.

BRIEF OF THE AMERICAN INSTITUTE OF ACCOUNTANTS AS AMICUS CURIAE.

SPENCER GORDON,
Attorney for American Institute of Accountants, amicus curiae.

COVINGTON, BURLING, RUBLEE,
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BRIEF OF THE AMERICAN INSTITUTE OF ACCOUNTANTS AS AMICUS CURIAE.

This brief is filed by the American Institute of Accountants, the national organization of certified public accountants. It is not directed to the merits of the case generally, but to a question of accounting principles involved therein, the determination of which is of great importance to the accounting profession and to the public which relies on reports made by accountants.

The Commission's order appears to have been entered pursuant to Section 301 (a) of the Federal Power Act, which authorizes the Commission to "prescribe a system of accounts to be kept by licensees and public utilities", and to "determine by order the accounts in which particular outlays and receipts shall be entered, charged or credited."

The Federal Power Commission, having found that common stock of a present par value of $3,500,000 was issued without consideration, and having ordered that the book asset created in respect of the supposed consideration received therefor be transferred to "Electric Plant Adjustments", made a further order in the following terms:

> "For each year, commencing with the calendar year 1940, it shall credit Account 107, Electric Plant Adjustments, and charge Account 414, Miscellaneous Debits to Surplus, with a sum equal to its Net Income (Account 400, Credit Balance Transferred from Income Account) less its Preferred Stock Dividend appropriations for each such calendar year until the amount of $3,500,000 shall have been entirely extinguished." (R. Vol. I, 18).

In its opinion, the Commission said:

> "Considering all relevant factors, we find that it is in the interest of consumers, investors and the public to direct the disposition of the $3,500,000 write-up by requiring the company to apply all net income above preferred stock dividend requirements to the disposition of the $3,500,000 in Account 107. This disposition, assuming adequate earnings, is the equivalent of obtaining ultimately from the holders of the common stock (the holding company) a consideration of $3,500,000 for the stock. Certainly dividends should not be paid on the common stock until it has the equivalent of a paid-in value." (R. Vol. I, 69.)

In the United States Circuit Court of Appeals for the Ninth Circuit, the Commission's counsel contended that the order as quoted above "accords with established principles of correct accounting", and it is reasonable to assume that the same contention will be made in this Court. This creates a situation in which the accounting profession is vitally interested. If the decision is sustained or reversed on a question of law, equity, or administrative policy, it will not affect the accounting profession as such. Mem-

bers of the Institute are concerned, however, with the possibility that a procedure which they believe is not consistent with sound accounting principles may be so described in a decision and thus be given a legal sanction. We shall endeavor, therefore, to show that the Commission's order as quoted above does not accord with established principles of correct accounting and is not supported by the evidence as to the accounting principles involved.

The Chief Accountant, called as a witness by the Commission, testified in part as follows:

> "As far as accounting principles are concerned, the amount, representing a write-up, should be removed from the books of the company. I believe that the Commission would be fully justified from the standpoint of accounting principles in ordering the amount written off or disposed of at once. A policy and not an accounting principle may call for spreading the amount over a reasonable period of years in the future. It is my opinion that if the Commission as a policy matter determines the amount should be amortized over a future period, such period should not be more than ten years, five years being a much more desirable period. In other words, the amount does not belong in the books of account at all, hence the period of amortization, if amortization is approved, should be as short as possible." (R. Vol. 1, 361.)

The statement made in the first sentence quoted is clearly an expression of accounting opinion, and, while there is accounting authority to the contrary,* the Institute, for the purpose of this argument, accepts it. The question then presented is: Granted that the amount should be removed from the books of the Company, what is the appropriate accounting method of effecting that removal?

The Chief Accountant for the Commission first states the relevant accounting *principle:* "I believe that the Commission would be fully justified from the standpoint of

* Paton Advanced Accounting (1941) pp. 508-9.

accounting principles in ordering the amount written off or disposed of at once." There are various ways in which removal might be accomplished.

In the next sentence the witness suggests not accounting principles but a *policy*: "A policy and not an accounting principle may call for spreading the amount over a reasonable period of years in the future." The witness elucidates this point by saying, "if the Commission as a policy matter determines the amount should be amortized over a future period, such period should not be more than ten years, five years being a much more desirable period."

It is apparent that the order of the Commission was not in accord with the accounting *principle* as laid down by the Chief Accountant, since the order did not require the amount to be "written off or disposed of at once." Moreover, the order was based on a fundamentally different *policy* from that regarded by the Chief Accountant as acceptable. By the application of accounting principles as stated by the Chief Accountant the amount of $3,500,000 would have been immediately removed from the books, although the effect might be to create a deficit with all the consequences that follow. By the application of the Chief Accountant's concept of policy, a charge fixed in advance would have been made annually against income or earned surplus and the removal of the amount of $3,500,000 would be assured within a fixed term, "not more than ten years, five years being a more desirable period." The effect of such procedure might be that the existing surplus would be exhausted and a deficit created.

By the application of the *Commission's order*, however, removal of the amount of $3,500,000 from the books would not be definitely assured at any date, nor would it be possible for the existing earned surplus or the net income available for dividends on the preferred stock to be affected by the continued existence of the item of $3,500,000 or part of it on the books of the company. All that would be assured would be that no dividend would be permitted to be paid

on the common stock until the amount of $3,500,000 should have been removed completely from the books.

The Commission's order (1) provided for the determination of net income and surplus available for dividends without any regard to the existence of the $3,500,000 item; (2) permitted the distribution to the preferred stockholders of income or earned surplus to the amount of the full dividend requirements; and (3) called for the disposition of the $3,500,000 only out of the undistributed net income or surplus that might remain after such distribution to the preferred stockholders over and above the existing surplus of approximately $1,000,000.

This order was appropriate to effectuate the view expressed by the Commission that "dividends should not be paid on the common stock until it has the equivalent of a paid-in value", although in view of the existence of the surplus the order may have gone further than was necessary to effectuate its purpose.

We submit, however, that the order was not appropriate to insure the removal from the books of the amount which the Chief Accountant for the Commission had testified ought as a matter of accounting principle to be "disposed of at once."* It is entirely conceivable that under the order the $3,500,000 item will never be disposed of, since the

* Mr. Van Scoyoc, the other accountant on whose testimony the Commission relies said (R. Vol. I, 488-489):

> "As a matter of accounting there are two avenues open for disposition of the items—one being a further writedown of the common stock such as accrued in 1936, and the other being the amortization of the item through Account 271, Earned Surplus."

This does not appear to support the proposition that it is good accounting to apply to the reduction of the account for an indefinite period such varying amount of net income as may remain each year after preferred dividend requirements. Mr. Van Scoyoc had stated categorically that he concurred in Mr. Smith's testimony relative to the accounting principles involved in the proceeding (R. Vol. I, 478).

disposition would be dependent on earnings to be realized in excess of the preferred dividends.

We submit that it would have a detrimental effect on all accounting if this Court should lend its support to the proposition that, where correct accounting calls for the removal of the amount of a debit balance from the books, it is a compliance with this requirement to apply to the reduction of the amount the balance that remains after net income has been determined and in part applied to dividends. We do not believe that any recognized accounting authority can be cited by the Commission in support of such a proposition. On the somewhat analogous question of provision for depreciation accounting, we believe that recognized authorities are in agreement that such provision must be systematic and based on objective evidence and cannot properly be made dependent on the amount of earnings that may happen to be available.*

As to whether the order of the Commission should be sustained or reversed we express no opinion. We urge, however, that if the order is sustained such a decision be promulgated as one based on considerations other than principles of accounting.

Respectfully submitted,

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* Montgomery Auditing Theory and Practice (6th Ed.) p. 491.

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SUPREME COURT OF THE UNITED STATES.

No. 195.—October Term, 1943.

Northwestern Electric Company and American Power & Light Company, Petitioners, vs. Federal Power Commission. } On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[January 31, 1944.]

Mr. Justice Roberts delivered the opinion of the Court.

Petitioners assert that an order of the Federal Power Commission made pursuant to its authority to prescribe a uniform system of accounts for electric utilities is invalid because in excess of the Commission's statutory power and in violation of the Fifth and Tenth Amendments to the Constitution.

Northwestern Electric Company is an operating utility all of whose common shares are owned by American Power & Light Company. Shortly after organization Northwestern issued 100,000 shares of $100 par common stock to promoters. Later the transaction was entered on its books as "Land and Water Rights" with a corresponding credit to "Common Capital Stock". Northwestern received no cash or property for the stock so issued. The company prospered and its common stock became valuable. In 1925 American purchased all the common stock for $5,095,346.48. In 1936 Northwestern was permitted by the regulatory authorities of the States of Oregon and Washington, in which it operates, to reduce the par value of its common stock from $100 to $35, thus reducing the outstanding common to $3,500,000. This reduction was made in order that the stock might then represent the fair value of the company's assets. Entries on the asset side were written down $6,500,000 to offset the reduction in common stock liability.

Acting under § 301(a) of the Federal Power Act of 1935[1] the Commission prescribed a uniform system of accounts for utilities

[1] 49 Stat. 847, 854; 16 U. S. C. § 825.

and ordered reclassification of their electric plant accounts with necessary adjusting entries to reflect such new classification as of January 1, 1937. Northwestern submitted a classification and the Commission, after investigation, issued a report thereon and requested Northwestern to submit a plan for disposition of the item of $3,500,000 upon its books and recommended that the amount should be transferred to Account 107—Electric Plant Adjustments pending submission of such a plan. Northwestern failed to comply with these requests and an order to show cause was issued upon which a hearing was held. The Commission found that the cost of the physical property was all represented by obligations issued by the company and that the common stock did not represent money or property received. The Commission further found that in the interest of consumers, investors, and the public, the $3,500,000 write-up to be entered in Account 107 should be disposed of by applying net income above preferred stock dividend requirements to its elimination, and added that this disposition would insure the company's receiving value to balance common stock liability and that dividends ought not to be paid on the common stock until it had an equivalent paid-in value. An order was entered requiring Northwestern to comply with the finding.

The Commission granted a rehearing only as respects the required disposition of the asset item of $3,500,000; but refused a rehearing on all other matters involved in the case. Northwestern obtained a review in the Circuit Court of Appeals,[2] which sustained the order as against Northwestern's contentions that the Commission was without power to make an order for the keeping of its accounts, because of existing State regulation; that the Commission's action was not sustained by the proofs before it, was an abuse of discretion, and constituted a denial of due process of law, since the system of accounts prescribed was to show the company's plant at the amount it cost rather than at its present fair value. Inasmuch as the rehearing was pending before the Commission on the disposition to be made of the write-up, the Circuit Court of Appeals declined to pass upon that matter.[3]

In connection with the rehearing, the Commission requested the company to suggest any disposition of the $3,500,000 item it thought appropriate. The company refused to make any sug-

[2] As authorized by Sec. 313 (b), 49 Stat. 860, 16 U. S. C. § 825*l*.

[3] Northwestern Electric Co. v. Federal Power Commission, 125 F. 2d 882.

gestion, its position being that the entry should remain in Account No. 107. The result of permitting it thus to remain in the plant and property accounts of the company would be a continuance of a showing on its books of actual asset value to balance the outstanding common stock liability. The Commission reaffirmed its order and Northwestern again sought review in the Circuit Court of Appeals. American, which had been permitted to intervene, joined in the application for court review. The Circuit Court of Appeals refused to disturb the Commission's order.[4]

The Commission's power to prescribe a uniform system of accounting and to require Northwestern to keep accounts accordingly is not open to doubt. Its action was fully justified by the Act,[5] the relevant provisions of which are within the legislative power.[6] The only inquiries now open are whether the order as to the disposition of the $3,500,000 item appearing in Account 107 goes beyond the Commission's statutory mandate or constitutional limitations. We hold that it does neither.

The case presents only a question of proper accounting. In the light of the admitted fact that there has been a write-up of three and one-half million dollars on the asset side of the accounts to balance a stock liability created by the company in the same amount, which represents no value received for the stock issued, any accounting which limits plant items to their actual value when and as acquired demands that this write-up be eliminated from the accounts. Those in which the company previously carried the item were "Land and Water Rights", "Miscellaneous Non Operating Intangible Capital", and "Organization". A mere write-up belongs in none of these accounts and cannot properly appear in any other account on the asset side of the ledger. If it should so remain, it would have to be in a new account reflecting present value in excess of actual cost which would, in effect, be a plant appreciation account and the Commission's form of

[4] 134 F. 2d 740.

[5] Sec. 201(a), 48 Stat. 847, 16 U. S. C. § 824 imposes regulations upon interstate utilities; Sec. 205, 49 Stat. 851, 16 U. S. C. § 824d gives the Commission authority to regulate rates, and Sec. 301 (a) requires the keeping of accounts by utilities and authorizes the Commission to make rules and regulations necessary or appropriate for the purposes of the administration of the Act.

[6] Kansas City Southern Ry. Co. v. United States, 231 U. S. 423; Norfolk & Western Ry. Co. v. United States, 287 U. S. 134; American T. & T. Co. v. United States, 299 U. S. 232.

accounting does not permit the carrying of any such item in the asset account since its system is a cost system of accounting.

The question is whether the write-up must be written off the books in some manner. Northwestern says it should not be, but it offered no evidence before the Commission to show that in accounts based upon cost any such item should appear in plant account or elsewhere. There was expert evidence by Commission's witnesses that it must be eliminated. Nevertheless the petitioners insist the Commission's order as to disposition is arbitrary. ~~In a brief filed by the American Institute of Accountants it is suggested that proper accounting requires the immediate elimination of the item by a single charge to earned surplus as~~ **Although, as suggested in a brief filed by the American Institute of Accountants, the Commission's prescribed method of eliminating the write-up may not accord with the best accounting practice, it is sustained by expert evidence.**[6] ~~is sustained by expert evidence.~~ It is not for us to determine what is the better practice so long as the Commission has not plainly adopted an obviously arbitrary plan.[7]

The objections based upon the Constitution are without merit and need but brief notice. That the accounting method prescribed interferes with the function of management to some extent is beside the point.[8] That the Commission's action prevents the company from redressing the deficiency of paid-in capital by entering among its assets appreciation of value subsequent to the issue of the common stock takes nothing from the company or the stockholders. Although if American had purchased the assets of Northwestern it might have been allowed to place among its assets on its own books the actual cost to it of the physical property of Northwestern, the fact is irrelevant upon the question whether Northwestern may carry a fictitious asset account representing estimated value of capital stock issued neither for money nor for property at exchange value.

Nothing in the statute or the order prevents Northwestern keeping other accounts if it so desires which will give information with regard to estimated present appreciated value of its assets.

We find nothing in the statute which would have prevented a readjustment of the common stock account or the earned surplus

[7] See Norfolk & Western Ry. Co. v. United States, *supra*, 141; American T. & T. Co. v. United States, *supra*, 236.

[8] Norfolk & Western Ry. Co. v. United States, *supra*, 143.

account if the company had been willing and had proposed such readjustment to bring the statutory accounts into line with the Commission's prescribed system.

The Commission's order does not violate the reserved rights of the states under the Tenth Amendment. We are not here concerned with what the regulatory authorities of Oregon or Washington may or may not demand or permit. Whatever that action may be, it is subordinate to Congress' appropriate exercise of the commerce power. The Commission's order does not purport presently to affect or constrain action by the states within their fields.

We are not called upon to make any decision as to the ability of the company legally to declare and pay dividends.

The petitioners attack the regulations as in conflict with the powers and the regulations of the Securities and Exchange Commission, which also has regulatory power over Northwestern; but an examination of the statute and of the orders and proceedings of the Securities and Exchange Commission satisfies us that no conflict exists.

The judgment is affirmed.